APPENDIX II: ECONOMIC BENEFITS OF DEFICIT REDUCTION

APPENDIX II:
ECONOMIC BENEFITS OF DEFICIT REDUCTION

Last month, the Congressional Budget Office released a study that illustrated the economic impact of both smaller and larger budget deficits compared to the current fiscal trajectory.[1] Under current law, debt levels as a share of the economy are poised to rise from just over 72 percent last year to 77 percent by the end of the ten-year budget window. Economists generally caution that government leverage in excess of about 60 percent of the economy is problematic, and a rising debt level is simply unsustainable for an extended period of time. A rising debt level is ultimately unsustainable because its growth exceeds that of the overall economy. As a result, debt-service costs absorb an increasing share of national income, and the country must borrow an increasing amount each year, likely in the face of gradually higher interest rates, to both fund its ongoing services and to make good on its previous debt commitments. Ultimately, this dynamic would lead to a decline in national saving and a "crowding out" of private investment, leading to a decline in economic output and a diminution of that country's standard of living.

CBO's study warns that the current debt trajectory "raises the risk of a fiscal crisis (in which the government would lose the ability to borrow money at affordable interest rates)." Looking ahead, CBO notes that "the aging of the population and rising health care costs will tend to push debt even higher in the following decades."[2]

For these reasons, CBO finds that reducing budget deficits, thereby bending the curve on debt levels, is a net positive for economic growth. CBO finds a dichotomy, however, between the short-term and longer-term impacts of deficit reduction. For instance, CBO's short-term economic models are driven mainly by demand-side factors. According to these short-term models, deficit reduction that lowers government spending leads to a temporary reduction in economic output due to the assumed reduction in consumption as a result of lower government transfers. These models assume government spending has a "fiscal multiplier" in excess of 1, meaning that its reduction leads to an outsized reduction in overall economic output. Of course, every dollar the government spends must be taxed or borrowed from the private sector.

Although CBO believes that deficit reduction may lead to lower economic growth over the short term, some economists offer a contrasting view. They argue that a country's debt build-up can be so large that longer-term fiscal concerns essentially start to bleed into the present, affecting short-term economic activity. The extreme example is a sudden, full-blown debt crisis like the one that fiscally troubled countries in Europe have experienced. But there is also a less-noticeable, slowly evolving type of crisis that can grip a debt-burdened economy—the

---

[1] Congressional Budget Office. "Macroeconomic Effects of Alternative Budgetary Paths." 5 February 2013.

[2] Ibid.

crisis of uncertainty and waning confidence in the will of policymakers to deal with the government's unsustainable fiscal trajectory. Investors and businesses make decisions on a forward-looking basis. They know that today's large debt levels are simply tomorrow's tax hikes, interest-rate increases, or inflation—and they act accordingly. It is this debt overhang, and the uncertainty it generates, that can weigh on growth, investment, and job creation.

For instance, Stanford economists John Cogan and John Taylor recently studied fiscal-consolidation strategies that use a so-called "Neo-Keynesian" economic model to take into account how consumers and businesses might react to a country's future fiscal trajectory. For example, forward-looking consumers and businesses may expect future tax hikes, and plan accordingly, if a country continues to build up large amounts of debt that will ultimately need to be paid off. In this study, Cogan, Taylor, and their fellow authors find that "even in the short-run, the consolidation of government finances is found to boost economic activity in the private sector sufficiently to overcome the reduction in government spending."[3]

Similarly, Taylor has argued that government needs to encourage private investment, rather than keep its own spending high, in order to grow jobs. He believes that vast uncertainty, linked to the possibility of higher future tax rates and interest rates, is having a chilling effect on private investment and therefore job creation. Reducing government spending now would "reduce the threats of higher taxes, higher interest rates and a fiscal crisis," and would therefore provide an immediate stimulus to the economy.[4] Although Federal Reserve Chairman Ben Bernanke has not said categorically that a deficit-reduction package would be a net positive for the economy in the short run, he does make the point that the announcement of such a plan would have near-term benefits. For instance, Bernanke has said that putting in place a credible plan to reduce future deficits "would not only enhance economic performance in the long run, but could also yield near-term benefits by leading to lower long-term interest rates and increased consumer and business confidence."[5]

Irrespective of the debate over the short-term economic impact of deficit reduction, there is widespread consensus that long-term fiscal sustainability produces considerable economic benefits. In CBO's analysis, a $4 trillion deficit-reduction package permanently increases economic output by 1.7 percent after 2017. The logic is that deficit reduction creates long-term economic benefits because it increases the pool of national savings and boosts investment, thereby raising economic growth and job creation. These benefits are both significant and lasting, in contrast to CBO's assumed temporary reduction in output over the short term.

The greater economic output that stems from a large deficit-reduction package would have a sizeable impact on the federal budget. For instance, higher output would lead to greater

---

[3] Cogan, John, and John Taylor, et al. "Fiscal Consolidation Strategy." Stanford University. 14 June 2012.

[4] Becker, Gary, George Schultz, and John Taylor. "Time for a Budget Game-Changer." *Wall Street Journal*. 4 April 2011.

[5] Bernanke, Benjamin. "Fiscal Accountability." 14 June 2011.

revenues through the increase in taxable incomes. Lower interest rates, and a reduction in the stock of debt, would lead to lower government spending on net-interest expenses. According to CBO, this dynamic would reduce budget deficits, or increase budget surpluses, by roughly $89 billion in 2023. Over the decade, deficits would be reduced by roughly $186 billion.

FY14 House GOP Budget and Macro-Economic Feedback Effects Resulting from Deficit Reduction (billions of dollars)						
	2023	**2023**	**2023**	**2014-2023**	**2014-2023**	**2014-2023**
	Budget without Feedback	Impact of Economic Feedback	Budget with Feedback	Budget without Feedback	Impact of Economic Feedback	Budget with Feedback
Outlays	4,954	-26	4,928	41,466	-75	41,391
Revenue	4,961	55	5,016	40,241	112	40,352
Deficit(+)/ Surplus(-)	-7	-82	-89	1,225	-186	1,040
Debt Held by Public	14,211	-185	14,026	n.a.	n.a.	n.a.

Note: Feedback effects are based on CBO's report on *Macroeconomic Effects of Alternative Budgetary Paths* using its illustrative path of a ten-year, $4 trillion reduction in primary deficits. The FY14 House Budget Resolution achieves deficit reduction well in excess of CBO's illustrative path.

Details may not sum to totals due to rounding.